TRENDS IN CHINA'S CONSUMER MARKET AND THE IMPLICATIONS FOR JAPANESE COMPANIES

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SUMMARY

- Under the two key policies of "dual circulation" and "common prosperity", the Chinese government aims to promote an expansion in domestic demand, greater sophistication of consumption, and the formation of high-quality domestic markets. China's middle-class population is estimated to reach 500 million by 2025, and personal consumption is expected to increase accordingly.
- The new trends emerging in China's consumer market include: (1) the emergence of new demand in tier 3 and lower-ranked cities, (2) a growing consumer preference for domestic brands, and (3) the expansion of the Direct-to-Consumer (D2C) business model.
- Chinese companies are securing consumer touchpoints through digital technologies, such as social commerce and live commerce, and are capturing global e-commerce demand. What Japanese companies can do amid this trend is to leverage their strengths in upstream fields and collaborate with Chinese companies to capture new demand and acquire know-how in the D2C area.

GOVERNMENT POLICIES DRIVING THE EXPANSION IN CONSUMPTION

Given the forecast that China's economy will become the largest in the world within 10 years, the Chinese government has formulated two priority policies, "dual circulation"[1] and "common prosperity",[2] and is working to create a consumer market on a par with the US, through an expansion in domestic demand and promotion of more sophisticated consumption.

China's middle-class[3] population has already reached 340 million[4], twice that of the US. With the possibility that this demographic could reach 500 million by 2025, the pace of growth in personal consumption is expected to accelerate. China's "common prosperity" drive focuses on the realization of both growth and wealth redistribution, and the policy guidelines announced at high-level meetings, such as that of the Central Financial and Economic Affairs Commission of the Chinese Communist Party held in August 2021, emphasize expansion of the middle class based on the equal distribution of income.

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1 The Chinese government proposed the "dual circulation strategy" as a new economic development strategy for the first time at the meeting of the Standing Committee of the Central Political Bureau of the Communist Party of China held on May 14, 2020. The strategy places emphasis on shifting to a domestic demand-led economic development model, the sophistication of consumption, independently developing core technologies, and attracting capital and human resources to China throughout the global supply chain.

2 In March 2021, "common prosperity" was set as the main goal of economic and social development in China's 14th Five-Year Plan. The Chinese government states that it has succeeded in eradicating absolute poverty, and its next challenge is to eliminate the problem of wealth disparity in order to expand domestic demand.

3 Although there is no standard definition, the Chinese government defines the middle class as households with an annual income of 60,000 yuan (approx. 960,000 yen) to 500,000 yuan (approx. 8 million yen), while McKinsey & Company defines it as those with an annual income of 75,000 yuan (approx. 1.2 million yen) to 280,000 yuan (approx. 4.48 million yen).
CSIS China Power Project, *How Well-off is China's Middle Class?*

4 HSBC Bank, *Mainland China's rising wealth,* https://www.gbm.hsbc.com/insights/global-research/mainland-chinas-rising-wealth
IZA Institute of Labor Economics, *The Rise of China's Global Middle Class in International Perspective*, https://ftp.iza.org/dp14531.pdf

This report illustrates the recent trends in China's consumer market, where domestic demand is expected to grow further owing to policy support, gives examples of initiatives taken by Chinese companies, and explores the implications for Japanese companies.

2. NEW TRENDS IN CHINA'S CONSUMER MARKET AND THE INITIATIVES TAKEN BY CHINESE COMPANIES

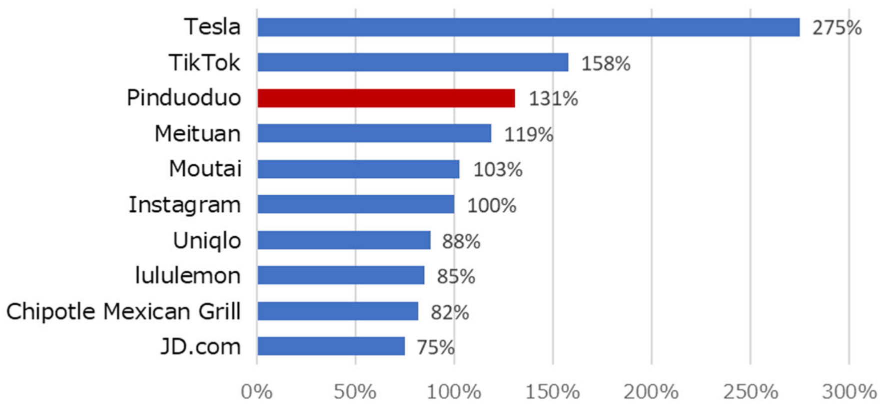
2-1. Pinduoduo capturing the attention and demand of consumers in tier 3 and lower-ranked cities

Arousing interest in China is the potential of consumption in cities classified as tier 3[5] or lower. In these regions, the low living costs, such as for housing, suggest consumers' disposable income may be higher than that of consumers in large cities. Other advantages, including short commuting times, give consumers more free time to spend on other consumption activities, such as hobbies and travel, and that is pushing up personal consumption. In some of these tier 3 and lower-ranked cities, the percentage of households with annual disposable income of 140,000 yuan (approximately 2.24 million yen) to 300,000 yuan (approximately 4.8 million yen) has risen to account for 34% or more of the population. This is close to the level of tier 1 and tier 2 cities five years ago, and the purchasing power of these households is surely increasing[6].

Pinduoduo is a good example of a company that has successfully stimulated e-commerce demand in tier 3 and lower-ranked cities by providing a "group buying" platform for the low-cost purchase of fresh foods, agricultural products, daily necessities, etc. Unlike Alibaba and JD.com, the company is unique in that it initially targeted tier 3 and lower-ranked cities, where the penetration rate of Internet infrastructure is low. The company well understands the characteristics of these cities' consumers who seek high-quality, low-priced products, and has developed effective product strategies that meet the e-commerce needs of such consumers. Pinduoduo saw the number of its users reach 849 million at the end of June 2021[7], only six years since its establishment, and it surpassed Alibaba to become the largest e-commerce company in China in terms of the number of users.

Another factor behind Pinduoduo's success is that the fee for using the platform has been set at essentially zero for participating sellers, such as SMEs and farmers[8]. This strategy gives the sellers on Pinduoduo a pricing advantage compared to sellers on other platforms, such as Alibaba and JD.com, as well as opportunities for receiving bulk orders. It thus makes it easy for the sellers to develop a framework for producing large quantities of high-quality products and supplying them at affordable price, and thereby improve their profitability. By increasing transactions on the platform through this virtuous cycle, Pinduoduo has created an advertising revenue model. The company has expanded its target market from its initial focus on consumers in tier 3 and lower-ranked cities to include tier 1 and tier 2 cities, and along with this, its brand recognition is heightening noticeably (Figure 1).

Figure 1: Growth rates of global brands in 2020 (YoY)



Source: Compiled by MGSSI based on Statista data (https://www.statista.com/statistics/268007/brand-value-change-of-the-largest-global-brands-in-2012/)

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5 CBN Research Institute, a think tank under the umbrella of the Chinese financial magazine publisher Yicai Media Group, ranked 337 cities in China from tier 1 to tier 5 based on population, economic development, and other parameters. In general, tier 3 refers to relatively developed small and medium-sized cities, but there are no clear administrative standards. The four tier 1 cities are Beijing, Shanghai, Guangzhou, and Shenzhen, which are direct-administered municipalities. The tier 3 and lower-ranked cities include Zhoushan, Chaozhou, Yangzhou, Tai'an, and Dezhou.

6 McKinsey & Company (2020 report).

7 Nihon Keizai Shimbun, August 27, 2021.

8 KDDI Research, Inc., https://rp.kddi-research.jp/article/RA2021013

2-2. Gen Z showing a preference for domestic brands and SHEIN expanding in overseas markets

Young consumers, such as those belonging to the Generation Z demographic cohort, who are central to the current Chinese consumer market, tend to choose the products of cheaper domestic brands if the quality is similar to higher priced items, rather than spontaneously choosing foreign brands. In a consumer survey conducted by the US consulting firm AlixPartners in October 2020, 66% of Chinese consumers said they would choose domestic brands over foreign brands, and the majority (62%) of those respondents cited their "patriotism" as the reason. The Ali Research Institute's "2020 China Consumer Brand Development Report" states that among the reasons consumers support domestic brands are the following: (1) the cost competitiveness when considering quality and price, (2) confidence in China's culture brought by an improvement in the country's international status, and (3) the Gen Zers' sense of connection with the domestic brands that were born around the same time as they were.

In this way, Chinese consumers' recognition of domestic brands has changed significantly over the last few years. There is also a trend among consumers to select domestic brands even for high-priced products, and they are paying more attention to not only domestic labels of apparel and electronic products but also those of cosmetics and wine. In addition to the successful IPOs of 11 domestic brands under the portfolio of venture capital firm Sequoia Capital China in 2020[9], other VC companies are also actively investing (Figure 2), suggesting a further increase in the number of domestic brands.

Figure 2: Financing status examples of Chinese domestic brands (consumer goods related, as of October 2021)

Company	Segment	Year established	Procurement amount (approx., JPY bn)
Peak Sport Products	Sportswear	1989	34
PatPat	Children's apparel	2014	17.5
Cider	Apparel	2021	14
Babycare	Baby products	2014	11.2
Bananain	Apparel	2016	7.8
Kilala	Contact lens	2020	6.8
Focallure	Cosmetics	2016	3.4
Chicecream	Confectionery (ice cream)	2018	3.4
BOP	Oral care	2019	2.8
C Coffee	Skincare	2021	1.7
SECRE COFFEE	Coffee	2019	1.7
Amos Food	Confectionery	2015	1.7
Flower Knows	Cosmetics	2016	1.7

(Reference: Examples of companies listed in 2020)

Company	Segment	Year established
Winner Medical	Medical supplies, mother & baby products	1991
Blue Moon	Household detergent	1992
BESTORE	Confectionary	2006
POP MART	Toys	2010
GENKI FOREST	Sugar-free flavored water and tea	2016
YATSEN	Cosmetics	2017

Source: Compiled by MGSSI based on materials of 36Kr, PitchBook, and others

[9] 36KrJapan, February 2, 2021, https://36kr.jp/116302/ Sequoia Capital China is highly regarded for its early investment in areas that have grown in China since its establishment in 2005, and its strategy of investing with the times. The company has positioned the consumer business as a strategic investment area, and the amount of investment in that area reached approximately 160 billion yen in both 2019 and 2020. Of the company's portfolio of investments, 11 companies, including POP MART (toys) and Winner Medical (medical products, mother & baby products), launched IPOs in 2020.

In contrast, fast fashion retailer SHEIN[10] is a brand that has grown by gaining strong support in foreign markets without calling attention to its Chinese origin. Established in Nanjing in 2008, the company is targeting Gen Zers overseas, attracting attention by hiring influencers who are popular on TikTok and other social media platforms, and issuing discount coupon codes. The company also offers several hundred to more than 1,000 new items online every week to successfully boost support for its brand. Being mindful of the fact that Chinese brands still have a negative impression in overseas markets, SHEIN has been successful due to the effectiveness of its strategies that highlight price competitiveness and quality, empathy with influencers, and the UX (user experience) on its app.

Supporting the low-cost products that became the company's solid advantage is a team of 800 designers formed in 2016 and a strong supply chain consisting of hundreds of affiliated factories that made it possible for SHEIN to respond to the rapid growth in demand. Backed by Gen Z demand around the world, the company now ships to more than 150 countries and regions, including the US, Europe, and the Middle East. In May 2021, its app became the No. 1 iOS download in the shopping segment in 54 countries. The company is exhibiting exceptional growth, with its sales reaching approximately US$10 billion in 2020 and corporate value estimated at over US$15 billion.

2-3. Expanding Direct-to-Consumer business model

In China, the digital economy's contribution to GDP has grown sharply from 14% in 2005 to 39% in 2020. In particular, the way brand retailers communicate directly with consumers is undergoing a revolution owing to both social commerce, where sales are driven by social networks and other forms of online media, and live commerce, where e-commerce is conducted through direct communication between consumers and sellers engaged in live streaming on social media.

The average Chinese consumer spends more than 7 hours a day on the mobile internet. About two-thirds of that time is spent on using social media apps[11], such as WeChat and TikTok, and consumer purchasing done by using them is becoming conspicuous. By selling directly to consumers (Direct to Consumer = D2C), brand developers can obtain more data on consumer purchasing behavior faster and at a lower cost, and develop new products and services based on insights obtained from verified purchases. In this way, it has become possible to respond ever more quickly to consumer needs, which are becoming increasingly individualized and diversified. Some D2C companies have been able to strengthen their brand recognition at no cost, such as by fostering an online community of users with the potential to become the company's fans and having existing fans serve as "brand ambassadors". These efforts are leading to more effective collection of behavioral data.

For example, Shanghai-based Makuku (Figure 3) has been developing products for the mother & baby market since its foundation and has built a long-term relationship of trust with customers through offline shop operations. The company has leveraged this trust into the creation of a membership-based social commerce model centered on the D2C concept, attempting to develop forums for sharing child-rearing knowledge, managing infant health, and organizing communities in the mother & baby product segment. Mothers can also organize communities by inviting people from their own networks to join and can even use it as a venue to start a business. Makuku, on the other hand, is increasing new consumer contacts by incorporating those networks. By responding to new consumer needs, the company is working to plant the seeds for the next business opportunity, while also looking to expand services from the post-childbirth market to include the pre-childbirth market.

Driven by such growth in direct communication between brand retailers and consumers through digital media, the size of the Chinese social commerce market is estimated to reach 2.9 trillion yuan (approximately 46.4 trillion yen) by 2021, and the live commerce market is forecast to reach 4.9 trillion yuan (approximately 78.4 trillion yen) by 2023[12].

10 Forbes, June 4, 2021, https://www.forbes.com/sites/markfaithfull/2021/06/04/fast-fashion-retailer-shein-could-become-latest-ipo/?sh=4d4941991b1c
11 McKinsey & Company (2021 report)
12 McKinsey & Company (2021 report)

Figure 3: Makuku, a D2C business operator in the mother & baby products market

Source: Makuku's website (http://www.makuku.com/)

3. IMPLICATIONS FOR JAPANESE COMPANIES

As detailed in this report, China's consumer market is showing new trends, such as the emergence of new demand in tier 3 and lower-ranked cities, a growing consumer preference for domestic brands, and an expanding D2C business model. Chinese companies have a significant comparative advantage in the digital domain, which is represented by drastic market changes, and where business models can be easily upended quickly. Specifically, Chinese companies have extensive expertise in building mechanisms for gaining consumer contacts by utilizing digital technologies, such as smartphone payment-based super apps, social commerce, and live commerce. At present, startups that were latecomers to the market are spearheading efforts in this regard.

In comparison, Japanese companies have exceptional experience and know-how of raw materials, product planning and development, service provision, and there is room for them to collaborate with Chinese companies. For example, the cosmetics sector is showing a new consumption trend of Chinese consumers seeking domestic brands. Young people are not picky about cosmetic brands and tend to use new brands one after another rather than staying loyal to Japanese or European products over the long term. Since there are no established domestic brands in this market yet, Chinese manufacturers are introducing formulations (recipes) from abroad and trying out various combinations. Because the companies are still at the stage of determining which recipe is likely to become established under which brand image, this is an opportunity for Japanese ODM manufacturers. To make the most of this opportunity, it is important for Japanese companies to explore collaboration not only on recipe development and raw material supply, but also for securing consumer touchpoints by establishing JVs with Chinese e-commerce companies.

In the various markets where consumption is getting more sophisticated and demand is growing more segmented, it is becoming increasingly important throughout the world to make use of digital means to secure consumer touchpoints, which in turn lead to the sources of profits. In doing so, it will become possible to meet the various needs according to the lifestyles of consumers, and based on that, companies can explore the diversification of business and new strategies to increase market share in each area. Japanese companies need to capture this new demand and acquire know-how in the D2C area by leveraging their strengths while collaborating with Chinese companies that are leading the way in this field.